INTERNAL REVENUE SERVICE

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April 30, 2002

LEGEND:

Company A =

Company B =

State A =

Number B =

Number d =

Number e =

Number f =

Date A =

Date B =

Date C =

Date D =

Date E =

Date F =

e =

f =

g =

Contracts =

Dear

This is in reply to your letter dated Date A in which you requested a waiver under section 7702(f)(8) of the Internal Revenue Code that various life insurance contracts (the "Contracts") will be treated as life insurance contracts for federal tax purposes. Further, you have requested that the proposed endorsement to bring the Contracts into compliance with section 7702 will not result in the loss of "grandfathered" status for purposes of sections 72, 264, 7702, and 7702A, nor require retesting or the beginning of a new test period under sections 264(d)(1), 7702(f)(7)(B)-(E), and 7702A(c), and that the proposed endorsement not be treated as an exchange for Federal tax purposes.

FACTS

Company A is a stock life insurance company, as defined in section 816(a) and is subject to taxation under Part I of Subchapter L of the Code. Company A is organized and operated under the laws of State A and is licensed to engage in the insurance business in Number B states. Company A joins in filing a consolidated return with Company B.

During the time the premiums are paid, the Contract's cash surrender value is the greater of (a) the minimum guaranteed amounts reflected in the Tabular Cash Value or (b) the Accumulation Value less any applicable surrender charge. The Accumulation Value is increased by premiums and interest (including excess interest) and is reduced by withdrawals and current contract charges, including any applicable surrender charges. The Accumulation Value is based on guaranteed interest of e percent compounded annually and cost of insurance (COI) guarantees that are a multiple, ranging from 150-300 percent, of the 1980 CSO rates reflected in the tabular Cash Value. The Accumulation Value is expected to grow more rapidly on a current basis than is guaranteed due to the crediting of excess interest and the imposition of lower-than-guaranteed cost of insurance charges.

The Contracts have minimum tabular cash surrender values dictated by minimum State nonforfeiture requirements (the "Tabular Cash Value"). The state nonforfeiture law generally requires the provision of a minimum cash surrender value that equals the excess of (i) the present value of future benefits over (ii) the present value of adjusted premiums due in the future. The Company calculated the Tabular Cash Value based on interest rates ranging from f compounded annually and reflecting mortality assumptions based on 100 percent of the Commissioners 1980 Standard Ordinary Mortality Tables ("1980 CSO"). Certain Contracts involved assumptions reflecting differing proportions of male and female mortality.

The Contracts were issued from Date B to Date C and were designed to comply with section 7702 by satisfying the "guideline premium requirements" of section 7702(a)(2)(A) and

(c) and by falling within the “cash value corridor” of section 7702(d). As of Date D, Company A had Number d Contracts in force. As of Date E, Number e Contracts do not meet the requirements of section 7702. Number f contracts had not failed the guideline premium test as of Date E but are scheduled, by their terms, to fail that test by Date F.

ERROR

Company A represents that an error occurred causing certain of the Contracts to violate the requirements of section 7702 because of its assumption regarding the relationship between the Tabular Cash Value and the Accumulation Value.

The intention of Company A’s actuaries was to design the Contracts where the Tabular Cash Value would control the determination of the Contract’s guideline premiums ensuring that the gross single or level premiums for the Contracts would equal the applicable guideline premiums. Company A analyzed section 7702 and its legislative history including the Joint Committee on Taxation’s General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, and specifically Footnote 53 contained therein, in designing the contracts. The Company believed based on these authorities and in particular Footnote 53 that with respect to fixed premium universal life insurance contacts, a contract could be designed to comply with the guideline premium test by its terms similar to the cash value accumulation test. Company A represents that its actuaries erroneously focused on the Tabular Cash Value as representing the cash surrender value on which the guideline premium calculation should be based. By design, the contractual guarantees underlying the Accumulation Value were insufficient to mature the Contracts. Company A assumed that the gross single or level premium could be designed so that it equals (or is less than) the guideline single or level premium, respectively, of the contracts. Thus, the fixed premium universal life insurance contracts could be designed so they comply with the guideline premium test by their terms. Company A and its actuaries believed that this was consistent with the purposes of Footnote 53. Thus, Company A looked solely at the assumptions underlying each Contract’s Tabular Cash Value rather than its Accumulation Value in calculating guideline premiums. In so doing, Company A’s actuaries did not recognize that the Accumulation Value exceeded the Tabular Cash Value on the Contract’s guarantees during some durations. Thus, Company A did not compare the Accumulation Value to the Tabular Cash Value at each duration to determine which was the appropriate value to use.

CORRECTION OF ERROR

Company A proposes to correct the inadvertent failure of the Contracts to satisfy the requirements of section 7702 by adding a cash value accumulation test (CVA) endorsement to the Contracts to provide term life insurance coverage that will increase the death benefits as necessary to assure compliance with section 7702. The CVA test factors are set forth in the endorsement. The factors are determined using 1980 Commissioners Standard ordinary (“CSO”) mortality, aggregate tobacco status rates, an annual effective interest rate of f, and an endowment date at the insured’s attained age 95. Company A represents that the CVA test factors are calculated in a manner consistent with sound and accepted actuarial practice and in accordance with section 7702(b). The Contract’s death benefits will equal the greater of (a) the death benefit presently provided by a Contracts and (b) a minimum death benefit that will be defined in a manner to ensure compliance with the Cash Value Accumulation test. Company represents that, under the terms of each Contract as amended by the Endorsement, the Contract's cash surrender value will not exceed the net single premium in respect of the Contract's future benefits at any time after the corrective action is taken. The amendments will not change the fixed premiums for the Contracts, nor will it result in any increase in the investment orientation of the Contracts. Company A believes that this action will not improperly discriminate against contract holders. Company A represents that the endorsement to each Contract will be issued to policyholders within 90 days from the date of this letter.

LAW & ANALYSIS

In general, for contracts issued after 1984, section 7702 provides a definition of the term "life insurance contract" for all purposes of the Code. To satisfy this definition, a life insurance or endowment contract must be treated as such under the applicable law. Pursuant to section 7702(a), contract must also satisfy either (1) meet the cash value accumulation test of subsection 7702(b) or (2) satisfy the guideline premiums requirements of subsection 7702(c) and fall within the cash value corridor test of section 7702(d).

Section 7702(b) provides that a contract meets the cash value accumulation test if, by the terms of the contract, the cash surrender value of the contract may not at any time exceed the net single premium which would have to be paid at such time to fund future benefits under the contract.

Section 7702(c)(1) provides that a contract meets the guideline premium requirements if the sum of the premiums paid under such contract does not at any time exceed the guideline premium limitation as of such time.

Section 7702(c)(2) provides that the term "guideline premium limitation" means, as of any date, the greater of (A) the guideline single premium, or (B) the sum of the guideline level premiums to such date.

The guideline single premium is the single premium at issue that is needed to fund the future benefits under the contract using the mortality and other charges specified in section 7702(c)(3)(B). Section 7702(c)(3)(B) specifically provides the guideline single premium is based on (i) reasonable mortality charges which meet the requirements (if any) prescribed in regulations and which (except as provided in the regulations) do not exceed the mortality charges specified in the prevailing commissioners' standard tables (as defined in section 807(d)(5)) as of the time the contract is issued; (ii) any reasonable charges (other than mortality charges) which (on the basis of the company's experience, if any, with respect to similar contracts) are reasonably expected to actually be paid; and (iii) interest at the greater of an annual effective rate of 6 percent or the rate or rates guaranteed on issuance of the contract.

The guideline level premium is the level annual equivalent of the guideline single premium payable until a deemed maturity date between the insured's attained ages 95 and 100, with interest at the greater of an annual effective rate of 4 percent or the rate or rates guaranteed on issuance of the contract. Section 7702(c)(4). The computational rules of section 7702(e) and the definitions of section 7702(f) apply to both the guideline single and guideline level premium.

The Joint Committee on Taxation's General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 describes the manner in which the net single premium or the guideline single premium limitation are to be determined.

> Also, if the contract's nonforfeiture values for any duration are determined by a formula that uses the highest value produced by alternative combinations of guaranteed interest rate or rates and specified mortality (and other) charges, the combination of such factors used, on a guaranteed basis, in the highest cash surrender value for such duration should be used for such duration in determining either the net single premium or the guideline premium limitation.

Footnote 53 in this passage illustrates this provision with respect to a fixed premium universal life insurance contract as follows:

> ... under a so-called fixed premium universal life contract, if the cash surrender value on a guaranteed basis (ignoring nonguaranteed factors such as excess interest) is not determined by the guaranteed interest rate and specified mortality and expense charges used to determine the policy value for some duration, but is instead determined by a secondary guarantee using the guaranteed interest rate and specified mortality and expense charges associated with an alternate State law minimum nonforfeiture value for such duration, the guaranteed interest rate and mortality and expense charges of the secondary guarantee are to be used with respect to such duration in determining either the net single premium or the guideline single premium limitation.

Staff of the Joint Committee on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 at 649 (Comm. Print 1984).

Footnote 53 is an illustration of the general rule provided in the legislative history regarding the determination of the guideline premium. The legislative history states that the guarantees that provide the highest cash surrender values should be used in a duration in determining the net single premium or the guideline single premium. Company A misinterpreted Footnote 53 in assuming that the Tabular Cash Value, which represented the "alternate State law minimum nonforfeiture guarantee", would always exceed the Accumulation Value. Actuaries misapplied Footnote 53 because the actuaries focused on the fact that the Accumulation Value could not mature a policy rather than focusing on the factors required to be considered in determining the guideline premium limitation on a universal policy.

Company A's actuaries focused on the fact that the Contracts would only mature using the Tabular Cash Value guarantees not the Accumulation Values and thus concluded these were the relevant values for calculations under section 7702. The intention of Company A's actuaries was to design Contacts so that the Tabular Cash Values would control the determination of Contracts' guideline premiums and that the gross single or level premium for the Contracts would equal the applicable guideline premium. The actuaries assumed the Contracts complied by their terms with the guideline premium requirements of section 7702 because the assumptions underlying the Tabular Cash Values are consistent with the computational rules of section 7702(c)(3) relating to interest, mortality and expense charges. The guarantees provided under the Accumulation value were insufficient to mature a Contract as opposed to the Tabular Cash Value. If there had been a direct relationship between the Accumulation Value guarantees and Tabular Cash Value guarantees, it would have been more apparent that the Accumulation Value guarantees were relevant to the guideline premium determinations. For example, if the determination of the next duration's Tabular Cash Value and Accumulation Value were dependent upon which method produced the higher cash valued in the preceding duration, Company A may have realized that not all durations were the same.

Company A has determined that the Accumulation Value prevails over the Tabular Cash Value at the time the contract was issued and for some period thereafter. After that period, the Tabular Cash Value prevails for the remaining life of the Contract. The length of the period during which the Accumulation Value prevails depends on the characteristics of the Contract involved, such as the age and sex of the insured at issue, the premiums paid, and the size of the death benefit provided. The length of the period also depends on the version of the Contract used.

Pursuant to section 7702(f)(8), the Secretary of Treasury may waive a failure to satisfy the requirements of section 7702. This waiver is granted if a taxpayer establishes that the statutory requirements were not satisfied due to reasonable error and that the reasonable steps are being taken to remedy the error.

Based on all of the facts, law, and arguments presented, we conclude that the failure of Number e and f contracts to satisfy the requirements of section 7702 is due to reasonable error. Company A's errors are reasonable within the meaning of section 7702(f)(8). Although Company A erred in its application of Footnote 53 in determining its guideline premiums, the errors are a possible misinterpretation of the mechanics of section 7702 with respect to these types of Contracts. The design of the Contracts was that the gross level premium of a Contract would equal the guideline level premium and therefore comply with section 7702. Company A believed this design would eliminate compliance concerns. Company A made assumptions that the Tabular Cash Value would always exceed the Accumulation Value.

We further hold that the correction of the errors described above will have no effect on the issue dates of the Contracts or on the dates on which they are considered to be "entered into" and will not be considered a change in benefits under section 7702(f)(7) or a material change under section 7702A. Thus, the addition of the endorsement, will not result in a loss of the "grandfathered" status for purposes of section 72, 264, 7702, 7702A, will not require retesting or the beginning of a new test period under sections 264(d), 7702(f)(7)(B)-(E), and section 7702A(c), and will not be treated as an exchange for Federal tax purposes.

We express no opinion as to the tax treatment of the Contracts under the provisions of any other sections of the Code and Income Tax Regulations that may also be applicable thereto.

This ruling letter is directed only to the Taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

A copy of this letter should be attached to the next federal income tax return to be filed by Taxpayer.

Sincerely yours,
DONALD J. DREES, JR.
Senior Technician Reviewer,
Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)